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SUBJECT: GROWING UK ISLAMIC FINANCE IS GOOD POLITICS AND GOOD BUSINESS

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Classified By: ECON Minister Sandra Clark; EO 12958 reasons 1.4(b) and (d)

¶1. (C) SUMMARY The UK government has a high priority goal to make London a center of Islamic finance to both assimilate the indigenous Muslim UK community(ies) and capture a niche market of high net worth Muslims internationally. The world market for Islamic finance grew from about $150 billion in the mid 1990's to $500 billion currently with forecasts of growth to $1.0 - $1.2 trillion by 2012. Although five year growth of $500 - $700 billion seems impressive, a global market for Islamic financing valued at $1 trillion will only be as large as today's market for domestic debt in the UK alone and will total less than 1% of the value of global debt and equity capitalizations. The UK government maintains a favorable regulatory regime for financial services generally and supports efforts to develop new shariah-compliant products and standardize terms and market practices. Because it is a niche market and because much Middle East liquidity is already invested in London in traditional investment instruments, the growth of Islamic finance has little potential to affect UK government policy. END SUMMARY

THE ISLAMIC FINANCE MARKET

¶2. (U) Limited hard data and poor transparency make it difficult to determine the size of the Islamic finance market. Rapid growth in recent years is clearly visible, but the structure of the market makes it difficult to pinpoint exact figures according to a June 6 Research Paper from Goldman Sachs (The Old Becomes New: Islamic Finance in Global Capital Markets, Global Economics Weekly, Issue No: 07/21, June 6, 2007) (Copy available on Embassy London Website at http://www.state.sgov.gov/p/eur/london/ and select Background on Britain / British Economy / Islamic Finance). The consensus estimate among analysts regarding current market size is $500 billion, up from $150 billion in the mid-1990's, as per a widely-cited estimate from Standard and Poors.

¶3. (U) Market participation has expanded beyond Islamic banks to include conventional banks, investment banks, and a range of non-bank financial institutions, including venture capital, private equity, microfinance, and housing cooperatives, according to the Goldman Sachs study. The range of Islamic finance products has likewise grown from its roots in commercial finance to include bond-like products, insurance, real-estate and infrastructure financing, and retail banking. London has come only recently to the Islamic finance market, following regulatory changes to allow non-interest bearing accounts to enjoy tax treatment similar to more traditional accounts.

¶4. (U) Global growth of 15% - 20% per annum in Islamic finance is likely over the five years to 2012 according to the Goldman Sachs report. Accordingly, the market will grow from the current $500 billion to $1.0 - $1.2 trillion by ¶2012. After 2012, the growth of the market is expected to slow as the current pool of excess liquidity will largely have been directed into shariah-compliant investment instruments.

¶5. (U) Although five year growth of $500 - $700 billion seems impressive, a global market for Islamic financing valued at $1 trillion will only be as large as today's market for domestic debt in the UK alone and will total less than 1% of the value of global debt and equity capitalizations, according to the Goldman Sachs research report. Although Islamic finance may never represent a significant portion of global financial market activity, it may have a significant impact on the recycling of petro dollars and diversification of the Middle Eastern oil producing economies.

ISLAMIC FINANCE: LONDON VS. THE U.S.

¶6. (U) The Goldman Sachs study and other observers conclude that the U.S. will participate only to a very small extent in the global Islamic finance market, mostly in Islamic mortgages. It is unlikely to become a major Islamic market for three reasons. First, the regulatory regime is not conducive to promoting Islamic finance. There's no unified regulator for tax, reporting, or trading Islamic instruments. States retain much autonomy over insurance products and taxation, making it difficult to standardize the treatment of Islamic finance products in these areas. The second reason is that New York has only a limited pool of qualified religious, financial, legal, and accounting talent to develop, issue, and trade Islamic financial instruments. Third is that New York is particularly remote in time and space. There is an 8 hour time difference between New York

and Dubai vs. 1 hour for London; and New York is 6800 miles from Dubai vs. London's 3400 miles.

¶7. (U) London benefits from a more favorable time zone, but it is the favorable regulatory regime in London that provides lasting competitive advantage over New York as a center for Islamic finance. The following illustrate the UK government's support of Islamic finance and the favorable regulatory climate in London.

--The Financial Services Authority (FSA) is the single regulator of Islamic finance, able to develop and maintain a comprehensive regulatory regime for Islamic finance that is equivalent to that for traditional financial instruments.

--The Treasury department (HMT) has eliminated the adverse UK tax consequences of Islamic finance instruments vis a vis traditional debt instruments benefiting from deductible interest.

--In January, 2007, Ed Balls, the then-UK Economic Secretary, announced measures leading to the first-ever issuance by a Western government of sukuk and making Islamic finance a key priority of the Chancellor's High-Level Group (HLG). Citigroup and HMT contacts confirm that HMT may be ready for its first sukuk issue as early as July, 2007. (Note: the HLG is a group of senior executives from across the financial sector charged with developing and supporting a strategy to promote London as the leading international financial center. End note).

--Secretary Balls's public support in January, 2007 of industry developments. First, a January, 2007 memorandum of understanding between the London-based International Capital Market Association (ICMA) and the International Islamic Financial Market (IIFM) to develop standardized contracts and documentation and market practices for sukuk. Second, the

launch of the Islamic Finance Qualification in October, 2006. This is a joint initiative to develop qualifications in Islamic finance between the Securities and Investment Institute, and the Ecole Superior des Affaires, one of the leading business schools in the Middle East.

--HMG hosted an April 16, 2007 summit of Islamic financial services experts and leading members of the Muslim community at No. 11 Downing Street.

--UK Trade and Investment (UKTI) was tasked with developing a strategy to make the UK a gateway for Islamic finance as part of their wider strategy of making London a leading international financial center.

OBSERVERS AGREE ISLAMIC FINANCE IS A SMALL MARKET BUT GOOD POLITICS

¶8. (U) Interlocutors from Citigroup, Morgan Stanley, Goldman Sachs, HM Treasury, and the office of UK Trade and Investment generally agreed on several points. First, Islamic finance will never make up more than a small portion of the total London market. Second, the principal UK government objective was to identify and remove structural obstacles to Islamic finance in the UK and then let the market determine what products to offer. Third, although the UK government support of Islamic finance was justified on purely economic grounds, the government recognizes that it is also good politics. Supporting Islamic finance at the wholesale level is expected to expand the UK availability of retail shariah-compliant products like home mortgages, insurance, term loans, demand deposits, and savings vehicles. These will benefit the sometimes marginalized 1.8 million Muslims in the UK, most of whom are neither rich nor Arab, but rather poor and South Asian. Fourth, the growth of Islamic finance has no potential to influence UK government policy. It is too small. London's reputation for high standards precludes undue influence. Additionally, since much of the liquidity going into Islamic products is already in London in non-Islamic products, Islamic finance offers increased choice for investors, but not increased influence.

¶9. (C) COMMENT: The UK has moved smartly to capitalize on its advantages in a niche market that complements its already broad array of financial products. So far, the banks have sought out high net worth Muslims, but the government expects product offerings will trickle down to the UK's large middle and lower class Muslim communities, giving them a greater economic stake in social integration. We agree with those who think that London is well positioned to benefit economically and politically from its support of Islamic finance but that there is little potential for investors in

Islamic finance to influence UK policy. The UK commitment to combat terrorist finance, for example, is not likely to be influenced by this market. If anything, the growth of a well regulated and transparent Islamic finance market might dry up legitimate business in the informal networks favored by terrorists and other criminals. END COMMENT

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